

KEYSTONE FINANCIAL PLANNING
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Going international helps retirees

The biggest question facing a retiree who wants to live partly off of an investment portfolio is this: Will the portfolio sustain my withdrawal rate, and keep up with inflation, throughout my retirement? Retirees don't want to run out of money before they die. But they also want a reasonable income that isn't devastated by inflation.

Much has been written about what is a reasonable, sustainable withdrawal rate. A sustainable withdrawal rate is one that will give the retiree a good chance of maintaining an adequate income over a lengthy retirement. The general wisdom is that a withdrawal rate of 5% or less—in some researchers' opinions, no more than 4%—will withstand just about anything the markets can throw at a portfolio. Even then there is disagreement over whether a portfolio of stocks and bonds will survive a lengthy retirement, even at a 4% withdrawal level.

How can a retiree hedge his bets and improve his chances of success? Retirement investors can improve their chances of success by putting part of their portfolios into international stocks and bonds. A recent study for the *Journal of Indexes* that used newly available long-term data for foreign markets found that a 30% allocation to foreign stocks and bonds dramatically improved the sustainability rates of portfolios with varying risk levels. The study used a new database of international bond and stock returns from 1900 through 2003. It constructed six different portfolios, ranging from 100% stock to 100% bond. Each portfolio had 30% of its assets in foreign stocks and bonds.

The results were striking. Over 30-year withdrawal periods, using an annual withdrawal of 4%, four out of five portfolios did better with foreign securities. The same result held true for a 5% withdrawal rate over 30 years. For instance, a portfolio with 40% of its assets in stocks and 60% in bonds, and that was partly invested in international stocks and bonds, had a 100% success rate using a 4% annual withdrawal, meaning that in every 30-year period the retiree did not run out of money, no matter what the markets did. The U.S.-only portfolio succeeded only 90% of the time. Over 40-year withdrawal periods the globally diversified portfolios beat U.S.-only portfolios at every risk level for both 4% and 5% withdrawal rates.

Why is this so? The open secret is that international stocks and bonds don't move in lockstep with domestic stocks and bonds. Also, their volatility levels are different than the volatility levels of domestic securities. Some analysts have argued that as commerce becomes more globalized, international investments will become more correlated with domestic investments. The *Journal's* study found that still has not happened. In fact, the correlations between foreign markets and the U.S. market have been higher during past periods than they are today. Although the long-term trend appears to be toward closer correlation of international and domestic returns, the study found that the correlations were higher in the 1920s, the 1930s, and the 1950s than they were in the 1980s and 1990s. "This points out that—contrary to popular opinion—recent correlations between U.S. and international assets are actually lower (and not higher) than some past correlations," it said.

Investors who want to prosper think long term

“Live long and prosper,” Leonard Nimoy’s character Spock, from the original *Star Trek*, liked to say. Investors—especially the media-bombarded impatient types of today—should take that adage to heart, perhaps substituting the word “Invest” for the word “Live.” In an era of second-by-second market updates readily available on cable TV and the Internet, investors seem to be having trouble with the concept of long term investing.

One major cable station starts out its morning financial coverage with a segment called “Trade of the Day.” Investors check their account balances daily, even hourly, online. Is this any way to make money? Clearly not: the markets can fluctuate widely and violently day-to-day and week-to-week. These fluctuations, however, mean nothing in the long term and tell you very little about the future. A smart investor shouldn’t worry about tomorrow’s account balance or how much he or she is likely to make or lose this year. Instead, the investor should be pumping every dollar possible into the market so that 15 or 20 years from now he or she can have bragging rights over the ensuing profits.

It doesn’t matter that the Dow Jones Industrial Average started 2005 at 10,783 and that it is below that level now. What matters for a long-term investor is that the Dow was at 1,198 at the start of 1985. Wouldn’t you have liked to have invested then and seen your money grow by 800%?

A smart investor is focused on 2025, not 2005. Where could the Dow be by then? Roger Ibbotson, a Yale professor and respected investment researcher, has predicted that the Dow would be over 100,000 in 20 years. Back in 1973, when the Dow was only 850, Ibbotson predicted the Dow would hit 10,000 in 1999. The Dow closed above 10,000 for the first time in March 1999. Ibbotson has predicted a median return of 11.6% per year for the big stocks that make up the Dow and that prediction underlies his forecast of a Dow above 100,000 by 2025.

What if returns are less? A 6% average annual return over the next 20 years will still boost the Dow to nearly 35,000 by 2025. That low return would still triple an investor’s capital. The lesson: ignore today’s market movements, put your money to work, and then sit back and relax and let the market take its course.

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